No. 10,373

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

MOHAWK PETROLEUM COMPANY (a California corporation), EDWIN V. MCKENZIE, as Executor of the Estate of Alfred L. Marsten, Deceased, EDWIN V. MCKENZIE, ALFRED L. MARSTEN, JR., and LEWIS A. MARSTEN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Upon Petition to Review Decisions of the Tax Court of the United States.

REPLY BRIEF OF PETITIONERS.

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A. THE MAIN ISSUE.

Respondent declares: "As long as the economic unit is still producing oil taxpayer suffers no loss from the retirement of a particular well. It will be, through depreciation allowances, fully compensated for the total cost of its entire investment in that unit when the last barrel of oil is extracted". (Res. Br. p. 25.)

(NOTE): All italics supplied by petitioner.

Among the petitioners are transferees who, by virtue of such status, are liable for this tax. Mohawk Petroleum Company, after the sale of all of its assets in 1938, dissolved, and distributed its assets to its stockholders, the transferee petitioners herein. It is clearly evident that unless the petitioners prevail in the instant proceeding they can never recoup the losses sustained on abandonment, because certainly no abandoned property was sold by the Petitioner to its successor, nor could such abandoned property have measured the price that Mohawk received on such sale.

Any statement, therefore, that these petitioners will be fully compensated for these sustained losses in the future is predicated on an erroneous assumption. But even if this were not true, even if the wells were still owned by Mohawk and continued to produce, the statement of Respondent would constitute no sufficient answer. One of the fundamental questions in the whole subject of income tax law is summed up in the single word "When": When does an item become income; when does an item become deductible? It is of almost the same importance as "Is this item income?", and "Is this item deductible?".

A yearly or any other period is arbitrary in an accounting sense. Tax law requires that income and deductions be fitted into an inelastic period of time, thus often resulting in manifest unfairness either to the Government or the taxpayer. To deny a loss actually sustained, when sustained, and justify it upon the assumption that later it will be recouped by the taxpayer through a depreciation account and thus make it chargeable, by a fiction, against a non-existent physical thing, is to deny

the time concept of money and to argue that money payable in a remote future is equal to money due today. And, further, it distorts the income for the year when the loss was sustained. By failing to allow a deduction, a false income appears upon which a tax is paid. In effect, the Government states: "You pay on the income which you never received and we will give it back to you some time in the future, but our promise to return it to you is contingent on many other factors, one of which is that you retain ownership of the property until the last drop of oil is produced from these lands".

Respondent further states, that "the method adopted by taxpayer is predicated upon precisely the same principle as the situation where a composite rate of depreciation based on the average lives of a group of assets is used. (See *U. S. Industrial Alcohol Company v. Commissioner,* supra.)" (Res. Br. p. 25.)

It is asserted that "In both instances the method adopted employs a rate which represents an average of the rates which would have been adopted had each asset been treated separately". It is declared that "In both instances the method adopted contemplates that some of the assets will normally be retired before and after the median factor upon which the rate was computed, and in both instances the method adopted will, by the time the last asset in the unit is retired, have returned to the taxpayer through depreciation allowances the full cost of its investment in all of the assets. In neither case, therefore, should a loss claimed for normal retirement in order to increase the amount of deductions for a particular year be permitted to thus distort income for that

year as long as all the assets in the group have not been retired." (Res. Br. p. 26.)

This is a convenient method of argument, but wholly without support. We emphatically deny that the method adopted by the taxpayer is predicated upon the same principle as the situation where a composite rate of depreciation based on the average lives of a group of assets is used, or that the Alcohol Case so holds.

The Revenue Act provides that a corporation may deduct from income losses sustained on abandonment of assets less salvage value. This is without question. A regulation provides for methods of computing a composite, or average, depreciation.

Either or any method of average depreciation may be used *if* it operates to prevent a double recoupment of the capitalized asset to the taxpayer; one, an entire return through depreciation, and the other through abandonment, discard or obsolescence loss. But equally important is the converse of the rule. And, this is the principle for which petitioner most earnestly contends.

Where a composite depreciation method is consistently used by a taxpayer which does not return to the taxpayer more than the capitalized value less salvage, *then* both abandonment losses and depreciation write-offs are permissible to such aggregate value. And, the abandonment loss can be written off in the year sustained. "Losses sustained * * * during the taxable year * * * are deductible * * *" (Pet. Br. p. 7.)

Logically, how may such self-evident proposition be denied? It is only when to permit a taxpayer an aban-

donment loss would be an addition to a recovery of the full value by depreciation that a deduction for such loss is properly denied.

If a deduction is denied upon the loss of an article, and if it is replaced by another similar article, how would it be treated? Keep both in a capital account and depreciate both? Or, if the article lost is not replaced, nevertheless maintain it as a capital asset? Or, charge it to a reserve to recoup the loss, not in the year sustained, but in other years by depreciation?

A taxpayer using a composite rate should be allowed a loss if a change of conditions necessitates replacing any asset which has been in use. To require that the loss be charged to the reserve would be to defer a deduction beyond the date of actual loss, and the Treasury, clearly, intended under the legislation to allow such a loss immediately subject only to the rule of no double recoupment.

We quote the Board in the *Pipeline* case:

> "The statute allows a taxpayer deductions for losses upon retirement of assets. It is of course proper to consider the method of computing depreciation and to see that double deductions do not result. There is in the present case no distortion of income resulting from double deductions in this connection. On the contrary, if the retirement losses are disallowed, the deduction for depreciation would have to be increased in order to reflect income correctly."
>
> *Illinois Pipeline Co.* (37 B. T. A. 1070, 1081).

Even where varying physical lives of several articles are used there are *two methods* of using such composite

base. Again we use the five articles example referred to in the *Alcohol* case. The two methods are shown in tables. (Pet. Op. Br. p. 17.)

In Example "D" the five articles, having a total cost of $50.00, are depreciated on a three year average life of 33⅓% with a full recoupment in three years. This must occur unless the $50.00 base is reduced each year by one-fifth the value. As pointed out in the Alcohol decision: "Depreciation taken on the full original cost basis would exhaust the total investment at the end of three years, and no depreciation would be allowable after that time, even though some of the assets would, by hypothesis, remain in use during the fourth and fifth years. Thus, for almost half the time, the taxpayer would be deprived of an annual deduction for depreciation". (*U. S. Industrial Alcohol Co.,* 42 B. T. A. 1323, 1376.)

It is certain that the method used by petitioner has no slightest resemblance to such average method. The rate here is not "keyed" to such an average. The second method is shown by Example "E". (Pet. Op. Br. p. 17.) "The cost basis is reduced as one of the assets is removed from the group by reason of normal retirement" (the "A" article of 1 year life) "* * * the gradually diminishing base and hence the reduced *amount* of depreciation" (as distinguished from the rate of depreciation) "will enable the taxpayer to continue to depreciate the assets remaining in each year at the composite rate throughout the fifth year, and the result will be an exact recovery at that time of the original cost of all the assets". *Alcohol* case, page 1376.

In Example "E" there has been an allowable depreciation ($33\frac{1}{3} \times \$50$) of $16.67, and there has been deducted from the base $10.00 for the purpose of extending the three-year average on a constant base to a five-year average, on a diminishing base.

> "It follows that, if an asset forming part of a group subject to a composite depreciation rate is retired because it has reached the end of its normal life" (meaning its normal life *computed* in arriving at the average) "only its elimination as the cause of additional deductions will avoid unnecessary, premature depreciation on the one hand or double deduction on the other." (Ibid. p. 1376.)
>
> "* * * assets which are retired at the end of their normal life" (meaning their normal life *computed* in arriving at the average) "cannot be permitted to furnish *further* compensation by way of a deduction for loss on retirement, even though they may be retired in advance of the average life of the entire group" (meaning articles of one year life to and including article of two year life). "Their early retirement" (meaning earlier than the average but not meaning earlier than normal and computed life) "will be compensated for by depreciation taken after the average period" (3 years) "has passed". (Ibid. p. 1378.)

Thus the one year and the five year article have a joint life of six years, and an average life of three years. The two extra beyond the average years of the five year life article have been added to the one year article, so the conception is that both have a three year life.

To apply this reasoning to Example "E": No deduction for a loss would be permitted if we added to the an-

nual write-off the amount by which the *base* is diminished each year, to wit, the sum of $10.00. Under such method, in each year there would be a dual write-off which, in the aggregate, would double the value of the five articles by way of recoupment to the taxpayer.

By Example EE:

	Loss Deduction	Amount of Depreciation	Total
1st Year	$10	$16.67	$ 26.67
2nd "	10	13.33	23.33
3rd "	10	10.00	20.00
4th "	10	6.67	16.67
5th "	10	3.33	13.33
Totals	$50	$50.00	$100.00

There is, therefore, no possible question respecting the rule and its proper application that, under certain definite circumstances no deduction loss can be allowed *if* it serves to allow the taxpayer a double recovery or any amount beyond the total sum invested in such assets less salvage.

> "Even stronger reasons require that there be no *excessive* compensation by permitting loss deductions upon *normal* retirements. Since a composite rate assumes that some assets will be retired before and some after the average, those reaching the end of their *expected* life, whether before or after the average do not result in any loss. And to permit any to

> be taken would tend to cause double deduction even more certainly than would the failure to reduce the base.'' |Ibid. p. 1377.)

But if four of the five articles expired at the end of one day, would it not be an absurdity to contend that no deductible loss occurred? Disregarding, in the calculation, the one day life of four articles, the taxpayer would sustain a loss of $40.00 less salvage, and should be permitted the deduction. The remaining five year life article would be depreciated $2.00 per year. ($10 x 20%.)

> ''What has been said, however, applies only to normal retirements; and the converse of the statement is also true. If assets are removed from the group as a result of abnormal retirements resulting from unanticipated causes occurring before the end of the normal life attributed to such assets in arriving at the composite rate, the resulting loss is the proper ground for a deduction. Such losses are not to be compensated for by way of depreciation, Southland Coal Co., 16 B. T. A. 50, and if not permitted as deductions will prevent the final recovery of the entire original cost.'' (*Alcohol* case, pp. 1378-1379.)

The Commissioner's rejection of the abandonment loss was overruled in that decision; and the abandonment losses were, in fact, allowed the taxpayer by the Board.

We find, therefore, that in ''physical life'' average depreciation cases the test is: How was the average life determined? What is the computed normal life of each article in the average? It is only the *computed* normal life span which has fixed the average and the rate. If an article fails substantially to attain that *computed* nor-

mal, then a deduction for an earlier retirement is allowable.

To this point we have not clearly shown the effect of the distinction referable to the instant case. The showing is foundational to the distinction between "physical life" and "economic life" cases.

A *sine qua non* to an average extending over the life of the longest lived article (5 years in the example, and not the three year average which would cause premature recovery in that period by depreciation of the full sum invested) is that the base must be reduced.

Again quoting the *Alcohol* case, page 1377:

> "The following statement in the case of Illinois Pipeline Co., supra, may at first glance appear to indicate the contrary: 'However, if the basis is reduced as assets are retired, the entire cost of the retired assets cannot be recovered unless the depreciated cost of the retired assets is allowed as a deduction at the time of their retirement'. This statement was undoubtedly correct as applied to the facts of that case."

So, it is beyond question that none of the assets in this case could have a longer useful economic life than the life of the oil lease. This life expectancy may be expressed as N years. There can be no question that neither the depreciation, the rate, nor the deductions have the slightest relation to the average physical lives of the separate assets.

> "Thus the depreciation there, and the deductions, being calculated upon the maximum economic life of the entire plant, not the average life of separate

assets, the loss deductions were proper." (*Alcohol* case, pp. 1377-1378.)

No question is raised by Respondent that the opinions in the *Alcohol* and *Pipeline* cases are not sound in law. The only contention is that because in the *Pipeline* case a twenty year life of an oilfield was assumed to arrive at the 5% rate and here the life of the field was not estimated in years, and the rate did fluctuate, there is such difference as to render the reasoning there applied inapplicable here.

We examine this contention. Reference is made to a statement by Respondent (Res. Br. p. 19), too lengthy to be quoted here. We set forth our precise contention on this issue: For simplicity we will disregard salvage and assume that in each instance it has been deducted.

The separate cost of the three wells is shown (Mohawk's books of account set out these separate costs) in the examples (Pet. Op. Br. p. 8), and the production on the same three wells appears. (Ibid. p. 9.) The aggregate of the separate costs is divided by the estimated potential reserves of oil with a resultant rate of 2.5 cents per barrel; the rate multiplied by the aggregate of the barrels produced equals the amount of depreciation taken.

To obtain the rate for the second year the reserves (computed at the beginning of the first year) must be lessened by the oil recovered (1,620,000—81,000=1,539,000 barrels). But assume that experience during the year has shown two factors; that the reserves were too high, and the engineer corrects the reserves from 1,539,000 barrels to 900,000 barrels. And, further that Well No. 1 has

been abandoned on the last day of the first year of its production. We had a capitalized cost of $10,000, reduced by salvage to $9,000, and depreciation of $500 (2.5¢ x 20,000 barrels) and a loss of $8,500. We have not only lost the well equipment but also part of the oil reserves through water infiltration. Wells No. 2 and No. 3 produce, respectively, 20,000 and 40,000 barrels during the second year. We then take the net cost, after salvage deductions, of $31,500, reduce it by depreciation previously taken in the first year of $1,525 (20,000 + 41,000 x 2.5) and use the remainder of $29,975 as the net remaining value to compute the rate. Therefore, 29.975 ÷ 900,000 barrels=3.33 cents per barrel, the rate. The same method is used successively through the years. It is a certain and customary method. Each year's production is precisely measured to the depreciated value (less salvage) of the equipment used during that year to produce that year's production. It is not disputed that this method returns *only* the cost. The net amount recovered by the taxpayer for abandonment losses is never recovered the second time by depreciation. From the time of such loss the depreciation no longer operates against the amount thereof. The economic cost of the well is the amount of the oil it produced during its life.

We apply Respondent's theory to the same situation. The rate is computed against $29,975 plus the deduction loss restored, $38,475 ÷ 900,000, the corrected reserves, equals a rate of 4.275 cents per barrel. On the two remaining wells on both theories depreciation is computed:

1st example: 60,000 x 3.33 = $1,988;

2nd example: 60,000 x 4.27 = $2,562.

In the first instance, the loss is taken when it in fact occurs and reflects a proper deduction to determine true income. In the second instance, it is postponed to be ultimately and fully recovered only when the last well on the property produces the last barrel of oil, perhaps twenty years hence. And if the property is sold no part of the purchase price can be measured against the non-existent asset. Nor may the capital account truthfully reflect such item.

Now, how does this occur? How is it possible, while denying the loss, to still ultimately restore it throughout a long period of years? The answer is perfectly obvious. The rate is raised. It is, in an economic sense, a false and wholly unjustified raise of rate, an expedient to take from a taxpayer unlawfully his money, and promise to ultimately restore it over a long period of years. Something like this always occurs when statutes and regulations are narrowly and literally construed. It never happens when the broad principle underlying a law is the measure of construction.

We now apply the same expedient of a change of rate to the *Pipeline* case, using a hypothetical value: Assume a value of $100,000 comprised of ten articles at $10,000 each. At the end of the first year, four articles are lost through abandonment. We have, then, $100,000 minus $5,000 depreciation, equals $95,000 undepreciated value. We have abandoned four articles each of a value of $10,000 less depreciation taken of $500 (4 x 9,500=$38,000). We write off the loss, $95,000—$38,000, leaving a remaining value of $57,000. To obtain the new rate we divide $57,000 by

19 remaining years,—equals 5.26. ($57,000 ÷ 19 = $3,000 = 5.26%.) Not only has the rate been changed, but the base as well.

If it be assumed that for some obscure reason the rate may not be changed from the initial 5%, then the base will have to be lowered. Where does that leave us? From the depreciated value of $95,000.00 we deduct $38,000.00, and have a balance of $57,000.00 which, multiplied by the rate, equals $3,000.00 per year. Therefore,

1 year's depreciation,	$ 5,000.00
19 years' depreciation,	57,000.00
Abandonment loss	38,000.00
	$100,000.00

If the reasoning used here were applied to the Pipeline facts, what would the conclusion be? On the $100,000.00 value straight line depreciation each year for twenty years would result in the return of capital. Both the rate and base remain the same. There is no diminishing base. The five per cent is computed always against the original cost. Any abandonment loss is recovered within the twenty year period. But the Tax Court held that *if* the basis is reduced as assets are retired (necessary in honest accounting?) the entire cost cannot be recovered unless the depreciated cost of the retired assets is allowed as a deduction at the time of their retirement. Of course this implies that if the rate is changed to offset the lowered base, then full recovery would result by depreciation.

It is clearly evident that if the retired articles are permitted to remain in the account the situation is identical in principle to this case. But the Tax Court refused, on

the soundest of reasoning to so conclude. The holding seems clear enough: that when articles are retired they must be eliminated from the base at the time of retirement.

And that which we said in opening is clearly applicable: It is, that none of the assets under those circumstances could have a useful life longer than the last barrel of oil produced, and since the rate was computed by a ratio of remaining unproduced oil to the cost of the equipment depreciated, such part of the assets having a shorter life measured by the last barrel of oil produced would be retired at a loss unless such shorter lived articles are permitted to remain in the account after retirement.

This was precisely the issue in the *Pipeline* case. There the amount of the loss could have remained in the account to be returned over a period of years through depreciation. The contention of Respondent there was rejected. The same contentions with the same result following thereon, ought to be summarily rejected, here.

B. THE MISTAKEN ASSUMPTION OF THE TAX COURT OF THE UNITED STATES.

The second contention raised by Respondent is:

> That there is nothing in the record to indicate that the well equipment became permanently worthless and that such equipment might have been available for use elsewhere; that the taxpayer must affirmatively establish a case within the applicable statutes, and a failure to do so precludes the allowance irrespective of the theory asserted by the Commissioner in denying the deduction. (Res. Br. p. 11.)

In support of the conclusion, Respondent cites general authority that no deductions for claimed losses will be permitted unless it is clear that the property has in fact become worthless during the year the loss is claimed (Res. Br. p. 30) and quotes from the opinion of the Tax Court of the United States in the instant case. (Res. Br. p. 31.)

Elementary principles are quoted to the general effect that:

A. The taxpayer must show that it is entitled to the deduction; and

B. Establish every element to show a case "squarely within the terms of the statute".

C. That if the disallowance is right it must be affirmed by the application of the correct rule of law. * * * irrespective of the theory asserted by the Commissioner. (Res. Br. p. 32.)

These citations are the basis of Respondent's declaration: "Nor is the taxpayer's position improved by its complaint that it was unable to anticipate the Tax Court's decision as to this point and was misled by the fact that the Commissioner had raised but one issue in his deficiency letter". (Res. Br. pp. 31-32.)

Here we find squarely presented an issue. The question ought to be judged, not alone by those considerations affirmatively set forth by Respondent but by the failure to consider the argument based on soundly reasoned authority urged by Petitioner. This issue is an ancient one between a narrow, strained and highly technical construction on the one hand, and a broad, liberal construction on the other. One defeats and wholly ignores the simplest

principles of fairness and the other requires a decision on the merits of a controversy.

In oil accounting, where the option of writing off intangible drilling expense is exercised by the taxpayer, the only capital account set up on the books is "Wells Equipment". "Wells Equipment" is in fact the "oil well" and represents the capitalized cost of that which is an integral physical part thereof. Against this capitalized cost, that is, tangible as distinguished from intangible cost, is first deducted ten per cent salvage merely to compute depreciation. It is the consistent practice of the industry, which was followed by petitioner, to compute this amount as being fairly representative of the value of "Wells Equipment" remaining when both its physical life referable to its original use and its economic life in producing the available oil has terminated. Depreciation rates were applied to the capitalized value *less* the salvage value. But the ten per cent factor is merely used as a preliminary estimate to obtain a proper base against which to compute the depreciation. Actually the loss in respect to abandonments is not ten percent; it may be fifty or any other percentage. The remaining undepreciated cost may be wholly lost.

In the instant case on two of the wells there was no salvage (Red Ribbon #6 and McKeehan #1) and on the others the actual salvage was credited to the loss. (R. pp. 53-54.) On McKeehan Well No. 3, the "tangible equipment removed from the well" was $1,479.75. That sum was credited to the cost of $16,549.36 and the resulting loss was $14,100.75. (The difference being previous depreciation.) On Earl Fruit Well No. 1, the "tangible

equipment removed from the well'' was $2,204.92; that sum was credited to the cost of $15,735.91 resulting in a loss of $13,530.99. (R. 54.)

The position taken by Respondent in effect denies this simple proposition and seeks a wholly arbitrary and erroneous—in fact—construction of a stipulation entered into by the parties before the Tax Board. We used the term which is the greater (oil wells), and, being greater, necessarily includes the lesser (wells equipment), that which is an integral part, and incident thereto.

The Petitioner ''wrote off'' the ''wells equipment'' because the wells ''became non-productive and were abandoned''. (R. 50.) We quote the stipulation: ''During the fiscal year ended September 30, 1937, petitioner wrote off as losses *consequent to the abandonment* of its McKeehan wells No. 1 and No. 3 and its Earl Fruit Company well No. 1, a total amount * * *'' (R. 53.)

We call attention to the computation of these losses (R. 54) which clearly and directly refute Respondent's contention that the ''wells equipment'' was not abandoned, in fact, contemporaneously with the abandonment of the oil wells.

Loss on McKeehan Well No. 3.

Total cost of tangible equipment capitalized	$16,542.36
Less salvage value of tangible equipment *removed* from well	1,479.75
Balance of equipment abandoned	$15,062.61
Less depreciation previously written off	961.88
Loss on McKeehan well No. 3	$14,100.73

Loss on Earl Fruit Company Well No. 1.

Total cost of tangible equipment capitalized	$15,735.91
Less salvage value of tangible equipment *removed* from well	2,204.92
Balance	$13,350.99
Depreciation previously written off	none

On Red Ribbon Ranch Well No. 6, "abandonment loss $5,044.03" (R. 53); "Loss on McKeehan Well No. 1, $7,394.80.

Can there be any possible question as to the true stipulation? It was agreed between the parties that:

A. The value of the equipment "removed from the well" was a definite fixed amount. (This is the only equipment that was or could be used thereafter.)

B. That the "balance of equipment abandoned" was a definite fixed amount. "During the fiscal year * * * *petitioner wrote off as losses consequent* to the abandonment * * *". (R. 53.) The agreed fact that certain equipment was abandoned expressly negatives the contention the wells equipment had not been abandoned, only the oil wells.

We emphasize that there is no issue of fact between the Commissioner and the taxpayer. The Commissioner accepted the accounts as reflected in the entries; it was agreed that certain oil wells had been abandoned, that certain equipment was saved, removed from the well and "that the balance of the equipment" had been abandoned.

Respondent seeks a decision on the merest quibble. The decision of the Tax Board was a mere inadvertence.

Here, there is no inadvertence. With all facts known, the sham contention is maintained.

No answer is made to Petitioners' argument that to abandon an oil well is to lose the surface string and the water string under California law requiring wells to be abandoned under a statutory method. (Pet. Br. p. 42.) Likewise, no reference is made to that line of tax decisions, that cases should be determined on the merits and not by strained construction of either stipulated or proved facts and that if the fact be doubtful further proof can be offered on a remand. Here we maintain that no remand is necessary because the stipulation, fairly construed, clearly supports the claim of Petitioner. In our opening brief we merely cited these cases. Here we briefly quote them:

Wyoming Investment Co., Ltd. v. Commissioner, 70 Fed. (2d) 191, 13 Amer. Fed. Tax Repts. 948 (10th Circuit, March 26, 1934):

"The taxpayer therefore produced no evidence to sustain the contention that the loss occurred in 1927."

The holding:

"The investment company was no doubt misled by the Commissioner's attorneys * * * and the erroneous statement of the issue at the hearing. * * * We are persuaded that on rehearing, the investment company will probably be able to establish that such stock became worthless during 1927. If this be true, the deduction should be allowed. We conclude that the investment company should be given an opportunity to produce further evidence and accordingly the case is remanded to the Board for rehearing on the correct issue".

Eau Claire Book & Stationery Co. v. Commissioner, 65 Fed. (2d) 125 (C.C.A. 7th Circuit, May 25, 1933):

"Likewise, we are satisfied that it would be in the interest of justice and fairer to both parties, if the cause were remanded, with opportunity given to them to supply, if they wish (Underwood v. Commissioner of Internal Revenue (C.C.A.), 56 Fed. (2d) 67) further evidence as to the value of the property and the services rendered with the giving of the notes, which were cancelled when the bonds were delivered. Likewise, the date of the sale of the bonds by the taxpayer to its stockholders might well be established with greater certainty".

Newell v. Commissioner of Internal Revenue, 66 Fed. (2d) 102:

"The evidence, however, is not sufficiently complete to warrant an attempt on our part to ascertain the amount of the company's loss through the death of the deceased, nor to say with finality and a reassuring degree of accuracy what effect the modification in the early capacity of the corporation would have upon the fair market value of the common stock. We conclude it would be fairer to both parties, and in the interest of justice, to reverse the order of the Board * * * and remand the case with directions to gather further evidence and make further findings on the controverted issues".

Commissioner v. Wright, 47 Fed. (2d) 871, at 872 (C.C.A. 7th):

"There was no evidence offered of its value at the time of surrender, and we deem it only fair that further opportunity be accorded the taxpayer for the

presentation of such evidence. Accordingly, the cause is remanded to the Board of Tax Appeals with direction to give opportunity for presenting evidence of the value of the stock at the time of the surrender.''

Underwood v. Commissioner of Internal Revenue, 56 Fed. (2d) 67, at 73:

''In addition, there is the well established rule that an appellate court has the power, without determining and disposing of a case, to remand it to the lower court for further proceedings if the case has been tried on a wrong theory, or the record is not in condition for the appellate court to decide the question presented with justice to all parties concerned. See Finefrock v. Kenova Mine Car Co. (C.C.A.), 22 F. (2d) 627, 634, and cases cited; also Seufert Bros. Co. v. Lucas (C.C.A.), 44 F. (2d) 528''.

Among others, Respondent asserts the following principle: If the disallowance is right it must be affirmed by the application of the correct rule of law * * * irrespective of the theory asserted by the Commissioner''. (Res. Br. p. 32.)

How does this save the situation? Factually, the Commissioner was right; so was the taxpayer. The ''wells equipment'' had been abandoned in part. There is no erroneous theory here. If on the main issue of law, it is held that petitioner is enttiled to the abandonment loss, there can be no slightest question that the loss was in fact sustained.

C. EQUITABLE RECOUPMENT.

Respondent states that Petitioners' main reliance is the decision of the Circuit Court of Appeals for the Eighth Circuit, in *Gooch Milling and Elevator Co. v. Commissioner,* 133 F. (2d) 131; and, that the overpayment in 1938 was occasioned by, and is, the result of the Commissioner's disallowance of the loss deductions claimed in 1936 and 1937, the taxable years in controversy. (Res. Br. p. 33.)

Respondent announces that a petition for a writ of certiorari has been filed by the Government in the *Gooch* case and that, in any event, the decision, in so far as here applicable, was incorrectly decided. (Res. Br. pp. 33-34.) In support of this view it is asserted that the Tax Court had no jurisdiction to decide in respect to any tax year not the subject of a deficiency; that the Tax Court may determine an overpayment only in respect of a tax year in which the Commissioner has determined a deficiency in tax. (Res. Br. pp. 34-35.) Respondent contends that the Gooch decision is erroneous because contrary to decisional authority and to the express terms of the statute.

It will serve no purpose to review the conflicting viewpoints in respect to this question. In a detailed and exhaustive opinion the Circuit Court has set forth its basic reasoning for the decision. It is applicable here to the same extent as there. Again, it is the old question of construction, a narrow, technical one resulting in flagrant injustice, an unconsciously, immoral judgment; the other, a broad construction resulting in a decision on the legitimate issue grounded on abstract right and wrong. We briefly quote from the opinion:

"In Dixie Margarine Company v. Commissioner, 6 Cir., 115 F. 2d 445, 447, the Court upheld the power of the Board to allow a recoupment based on an overpayment of tax for a prior year, although right to sue to recover same was barred by the statute of limitations. In the course of the opinion it is said 'in the present case, the claim for refund and the deficiency assessment had a common origin, namely, the erroneous application of the Oleomargarine Act to petitioner's product, and petitioner's claim is therefore available in recoupment.

'The Board has no occasion to consider whether the statute of limitation affected the availability of petitioner's claim in recoupment. We think it did not.' The Board having failed to permit recoupment, its decision was reversed and the case remanded for further proceedings in accord with the views expressed by the Circuit Court of Appeals.

Respondent quotes that part of the above statute which contains the limitation on the power of the Board, but we think it important to observe that the statute specifically provides that the Board 'in redetermining a deficiency in respect to any taxable year shall consider such facts with relation to the taxes for other taxable years as may be necessary correctly to redetermine the amount of such deficiency'. It should be considered as a whole and, if possible, all its provisions given effect. Jones v. York County, 8 Cir., 47 F. 2d 837. Unlimited power is vested in the Board to investigate and consider the facts with relation to the taxes of other taxable years in determining deficiencies of any particular year. The limitation is to the effect that the Board shall not 'determine' that the tax for any other taxable year has been overpaid or underpaid. Whatever facts

with relation to the taxes of other taxable years may be necessary in order to determine the amount of the deficiency may be considered."

In a footnote (Res. Br. p. 33), Respondent computes the amount affected by the recoupment plea, and declares: "It seems clear, therefore, that the $5,660.87 overpayment for 1938 was due *only in part* to the Commissioner's disallowance of the loss deductions claimed here". (Ibid. p. 34.)

In this calculation Respondent is in error, and we assume that counsel will admit same on argument if our explanation convinces.

Reference is made to "Adjustments to Net Income Fiscal Year Ended Sept. 30, 1938" (R. 26):

Net income as shown on return and upon which tax was paid........		$507,623.32
In the capital gain adjustment of $134,453.89 (R. 27) was the reduction of capital gain on sale of oil wells due to increased depreciated net cost consequent to disallowance of abandonment basis in prior years of		
Red Ribbon Ranch #6, abandonment loss disallowed	$ 5,044.13	
McKeehan #3, abandonment loss disallowed	14,100.73	
McKeehan #1, abandonment loss disallowed	7,394.80	
Earl Fruit #1, abandonment loss disallowed	13,530.99	$ 40,070.65

Net income excluding all other net adjustments made by Commissioner (R. 29-30)	$467,552.67
Computation of tax (see computation (R. 30)) as basis of this computation:	
Normal tax net income excluding other adjustments	$467,552.67
Dividends received credit	7,208.00
Normal tax net income...........	$460,344.67
Tax computed on said net income	$ 67,891.70
Amount assessed and paid on original return	73,902.30
Overpayment due to reduction of capital gain consequent solely to disallowance of abandonment losses in 1936 and 1937.........	$ 6,010.60

There were other adjustments of capital gains, both debits and credits, the net of which is reflected in the difference between	$469,844.22
appearing in the record (R. 30) and the above amount used herein of net income reflecting only the abandonment loss items...........	467,552.67
Difference	$ 2,291.55
The tax thereon was...........................	$ 349.73

Conclusion:

From the refund amount due solely to abandonment losses	$ 6,010.60
is deducted that which taxpayer owed due to the net of all other adjustments...........	349.73
Leaving a net balance due taxpayer of.......	$ 5,660.87

which is the amount set forth by Petitioner.

D. THE TEXT WRITERS.

The several tax service organizations employ text writers to digest, analyze and comment on all decisions; these services are sold to attorneys and income tax consultants. They also publish advance letters reviewing these decisions. We quote herein one of these comments issued by the Alexander Publishing Company (111 Wall Street, New York City) from the "Alexander Tax News Letter":

> "ABANDONMENT LOSS DENIED: CASE VERY DOUBTFUL: News Letter does not like to take 'time out' to be listing doubtful opinions, but there are so many lately against taxpayers that some of them simply MUST be listed. In a new Tax Board case, taxpayer had physical equipment in several oil wells on leased property. It depreciated such equipment on each well based on the number of units (barrels) that the entire lease was supposed to produce. Tax Board concludes that this is the same as taking a 'composite rate' of depreciation on all physical assets of the taxpayer. That, however, is not the point. Assuming that there has been a composite rate used for all the physical assets on the leased property, the Tax Board then concludes that the taxpayer may not take deductions for wells actually abandoned. In this case, the abandonment losses were substantial. The proposition, expressed in simpler language is this: Tax Board concludes that where a taxpayer is taking a composite rate of depreciation against any and all its assets, it may not deduct in any one year a special amount for abandonment. Board concludes that the depreciation rate allows for normal discards, hence no loss may be taken for them. Opinion appears entirely erroneous. (Mohawk Petroleum Co., 47 BTA No. 130, Alex. Par. 1801.600.)
>
> COMMENT: In Feb. and Apr. 1934, Treasury issued *TD 4422* and *Mim. 4170* which thereafter required

more extensive proof from taxpayers as to depreciation actually deductible. Among other statements in the rulings was this: 'Losses claimed on the normal retirement of assets—are not allowable, as the use of an *average rate* contemplates the normal retirement of assets both before and after the average life has been reached'. *Art. 23(e)-3,* Regs. 94, contains exactly this language also. They appear wrong. A composite or average rate does not necessarily contemplate losses from discards as being included. According to the Treasury's assumption, if a 10% rate is being taken, then 9% is for actual wear and tear and 1% for retirements or abandonments. Not so. Depreciation is an issue of FACT, not LAW. It is up to the taxpayer to prove whether or not his composite rate includes an extra amount for retirements; it is not up to the Treasury to force such conclusion in all cases. However, the particular case seems to have gone entirely wrong in its reasoning. It quotes case of *U. S. Industrial Alcohol Co.,* 42 BTA 1323, as denying losses for abandonments, and this is the only authority cited. Strange to relate, the Industrial Alcohol case ACTUALLY ALLOWED ABANDONMENT LOSSES despite a composite rate. However, it is possible to go further; in *Illinois Pipe Line Co.,* 37 BTA 1070, taxpayer owned assets—cost $18,000,000, which had been depreciated at composite rate of 5% since 1915; in 1929 and 1930 it discarded $345,000 and $70,000; both deductions allowed as losses on the theory that there was THAT MUCH LESS IN ASSET VALUES to depreciate after 1930. This case is not mentioned in new Tax Board case. In *Mason City Tile Brick Co.,* 36 F Supp 515, exactly similar conclusion was reached. Taxpayer had used composite rate but was allowed abandonment deduction. In new case, abandonment losses from wells were substantial. No question exists but that losses were deductible. All three cases

mentioned (*Industrial Alcohol, Illinois Pipe Line* and *Mason City*), allow losses where *composite rate used and discards are substantial*—and this is *exactly the situation in new case*).'' (Tax Letter Nov. 6, 1942.)

E. CONCLUSION.

In conclusion: Whether more or less depreciation was taken, whether one or another method was used to ascertain the amount, becomes wholly immaterial on the abandonment of the asset; only the capitalized value, less salvage, and previous depreciation is returned to the taxpayer: If the depreciation was less, the loss would be greater, and the converse is true.

How may it be logically inferred that the loss of these producing oil wells were normal losses and their respective lives were used to ''average'' same with other wells on the several leases?

The abandoned wells never produced the amount of oil in conformance with their potentials. This is shown by the fact that the abandoned losses were very high compared to capitalized costs. The Red Ribbon Well had a cost of $9,093.60, and the loss was $4,049.47; McKeehan No. 1, a cost of $22,304.17, and a loss of $7,394.80; McKeehan No. 3, a cost of $16,542.36, and a loss of $14,100.73; and Earl Fruit No. 1, a cost of $15,735.91, and a loss of $13,530.99. So, it appears that the aggregate capitalized cost of the four wells was $63,676.04

With depreciation of	$19,920.72	
And abandonment loss of	40,070.65	
And salvage of	3,684.67	$63,676.04.

If the Tax Court was correct in the *Alcohol* and *Pipeline* cases, and if the District Court was likewise correct in *Mason City Brick and Tile Co. v. Huston,* 36 Fed. Supp. 515, the Tax Court erred in the Mohawk case.

Dated, San Francisco,
June 23, 1943.

Respectfully submitted,

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